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ABSTRACT

This guide is intended to assist directors and board members of foundations affiliated with public institutions as they manage investments and assets of their institution. Introductory information notes duties of foundation directors and legal criteria for prudent investing under the Uniform Prudent Investor Act. Suggestions for developing spending and investment policies include finding the right investment consulting service, setting overall investment goals and objectives, and stating them in a formal document. Three subsequent activities are urged: (1) develop an Investment Goals and Objectives Statement and an Asset-Allocation Plan; (2) select an asset manager; and (3) prepare profiles of managers under consideration. Suggestions are also offered for on-going performance evaluation of the manager and for evaluation of fund performance. Briefly addressed are two special issues for foundations: actual or perceived conflict of interest, and social-issue or political-issue investing. (Contains 12 references.) (DB)

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BOARD BASICS

FOUNDATION RELATIONS

ASSET MANAGEMENT FOR PUBLIC INSTITUTION FOUNDATIONS

BY DAVID W. BAHLMANN

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Asset Management for Public Institution Foundations

Board members of foundations affiliated with public institutions and systems have no greater responsibility than to oversee the policies and processes concerning investments and asset management. To carry out this large and complex responsibility, foundation board members (often called directors) must develop appropriate spending and investment policies, secure outside professional counsel, set goals and objectives, and retain and evaluate external fund managers.

As they do so, foundation directors are wise to be mindful of their three basic duties, as defined by numerous common law courts. Those responsible for the management of charitable organizations (including public institution foundations) must adhere to the following:

Duty of care: Directors are entrusted with stewardship of assets for the benefit of the public served by the corporation and should act with the care of a reasonably prudent person.

Duty of loyalty: Directors must avoid conflicts of interest and are prohibited from using their position to further their private interests.

Duty of obedience: Directors must adhere to applicable statutes and the corporation's articles of incorporation and bylaws.

Directors have some measure of protection, however. Most states have adopted statutes granting some immunity from civil liability in certain circumstances for volunteers who act negligently, unless they acted knowingly or with gross negligence. Also, many state laws allow nonprofit corporations to specify in their articles of incorporation or bylaws indemnification of officers and directors who are charged with misconduct.

DIRECTORS MUST ADHERE TO APPLICABLE STATUTES AND THE CORPORATION'S ARTICLES OF INCORPORATION AND BYLAWS.

Additionally, nonprofit organizations may purchase directors' and officers' liability insurance or association professional liability insurance.

In any event, foundation directors and the professionals they hire and direct are required to "do well" in addition to their historical motivation to "do good." The concept of "doing well" is particularly important in investments and asset management.

THE LETTER OF THE LAW. Investment practices have changed significantly in the past few decades. Specifically, the Prefatory Note to the Uniform Prudent Investor Act (UPIA), drafted in 1994 by the National Conference of Commissioners on Uniform State Laws, specifies five fundamental changes in criteria for prudent investing. It cites the following:

- The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting, the term "portfolio" embraces all the trust's assets.
- In all investing, the tradeoff between risk and return is the fiduciary's central consideration.
- All categorical restrictions on types of investments have been abrogated; the trustee can invest in anything that appropriately helps achieve the risk/return objectives of the trust and meets other requirements of prudent investing.
- The long-familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.

- The much-criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation now is permitted, subject to safeguards.

The note further points out that board members of charitable corporations have duties similar to those of trustees of charitable trusts and "absent contrary statute or other provision, the prudent-investor rule applies to investment of funds held for charitable corporations."

Thus, institutionally related foundations are charitable corporations and subject to UPIA. All foundation boards should consult with their own legal counsel to institute or update policies and procedures to ensure compliance with the criteria.

About 88 percent of public institutions surveyed in 1995 had finance or investment-management committees, but only 69.5 percent had adopted formal policies on asset management and investment, according to a study conducted by AGB and the Council for Advancement and Support of Education. These statistics suggest many institutions—despite legal and historic responsibilities and precedent—have yet to set these essential policies. Survey evidence suggests that the noncompliant foundations hold assets of $10 million or less and perhaps feel less eager to set investment policies. The size of a foundation's holdings is irrelevant, however. All trustees who are responsible for assets are charged with the same degree of responsibility and care.

How do foundation directors go about carrying out these serious duties? Regardless of a foundation's size, age, or degree of complexity, the board should begin by assessing the needs of the foundation and the institution it serves.

DEVELOPING SPENDING AND INVESTMENT POLICIES. In their 1995 paper, "Foundation Investments: Policy, Asset Allocation, and Performance," Dennis H. Verity and Scott G. Thayer advise foundations to set and apply investment policies that complement spending policies. A spending policy determines how much to spend for present-day needs and how much to reinvest to preserve future spending power. "A well-defined spending policy," the authors say, "leads to a properly defined investment policy, which improves long-term investment results."

More specifically, Verity and Thayer say the spending rule "defines the annual percentages that will be withdrawn from the fund to be spent on program payouts and administrative and operational costs. Annual spending rules at 5 percent (or more) of fund market values are considered high by contemporary standards and may result in negative growth of fund values (loss of future spending power). Appropriately defined spending rules become essential in an inflationary environment to protect and sustain the 'real' (inflation-adjusted) value of principal assets. A fund cannot maintain the real value of its portfolio or its future grants if payout exceeds real return (actual net return minus inflation)."

Verity and Thayer further point out that present-day spending rules annually pay out a fairly constant percentage of the total market value of the fund regardless of whether the dollars spent are dividends, interest, or capital gains. They advise that "investment policy should be formulated to achieve 'total returns' (capital appreciation and income). A spending policy that balances current and future spending can be redefined by a basic formula that links the fund's annual growth (total return) with costs (spending and inflation)."

After determining the foundation's needs, directors should turn their attention to setting an investment policy that will achieve the desired results annually. Such an assignment might be delegated to a board committee. As foundation directors analyze the foundation's overall spending and investing needs, they will gain knowledge and insight to engage a professional consultant who can help guide them through the remaining process.

FINDING THE RIGHT HELP. Seeking consulting services is a multifaceted process. Invariably, someone on the foundation's investment or finance committee will know and suggest a consultant, thereby severely compromising the selection process before it begins. It is extremely important to set ground rules for the hiring process before any names of individuals or firms are suggested. A successful search for an investment consultant depends on the committee members' ability to identify the foundation's needs.

A SUCCESSFUL SEARCH FOR AN INVESTMENT CONSULTANT DEPENDS ON THE COMMITTEE MEMBERS' ABILITY TO IDENTIFY THE FOUNDATION'S NEEDS.

This process is doubly important because the consultants or firms the committee elects to interview can provide (or promise to provide) virtually any service committee members can imagine. However, most foundations don't need all possible services, even if they are included in the consultant's base fee.

What can foundation directors expect from consultants? *Improving Endowment Management*, a study conducted by the Academy for Educational Development with the American Council on Education and AGB, suggests investment-management consultants generally offer similar core services covering most areas of fiduciary responsibilities:

- review, help to develop, or refine investment policy;
- suggest objectives and policy guidelines (including spending policies);
- help plan for asset allocation;
- evaluate historic and current investment performance;
- help select and evaluate a master trustee/custodial bank; and
- conduct special studies (social investing, securities lending) and distribute the results.

In addition, outside counsel can lend perspective on the important distinctions between institutional and personal investing (a distinction that can become blurred), and they can help educate and inform foundation directors about institutional investment in general.

Some consulting firms offer optional services, including transaction cost analysis, commission recapture, preretirement planning, participant education for defined contributions, materials development for donor reporting and fund-raising, and investment-strategy topic reports on current issues of interest to institutional investment programs.

These supplementary services are appropriate for some foundations but not all. Every foundation must balance offered services with real needs. The rule of thumb in purchasing outside consulting services is to seek only the services required.

THE FOUNDATION BOARD'S MOST IMPORTANT RESPONSIBILITY REGARDING ASSET MANAGEMENT IS SETTING INVESTMENT GOALS AND OBJECTIVES, THEREBY DETERMINING ASSET ALLOCATION.

Setting Investment Goals. The foundation board's most important responsibility regarding asset management is setting investment goals and objectives, thereby determining asset allocation. Research shows that more than 90 percent of the total return of a foundation's assets is the result of asset-class decisions. Sound asset-allocation decisions allow the foundation to honor current and future spending policies, maintain stability, and achieve long-term goals and objectives.

Since this function is so significant to the foundation's overall effectiveness, the investment committee must receive the best support and guidance possible. Communications among all parties must be complete and timely. Foundation officials must pay careful attention to detail and ensure all perspectives are heard.

Overall investment goals and objectives vary widely, but successful ones share basic components. The following should be addressed in a formal document:

- ***General history and purpose of the fund.*** This includes the host institution's mission and a statement of the philosophy that guides the foundation board, its investment committee, investment consultant, and appointed investment manger(s) toward desired performance.

- ***Investment objectives.*** These are the overall objectives of the investment policies, including the expected return stated in a total-return format and the risk tolerance of the foundation board.

- ***Payout/liquidity requirements.*** These define the rate and method of calculation and the timing of distributions from the funds the foundation requires to operate its programs.

- ***Asset-allocation policy.*** This identifies approved asset classes, policy levels for each class, rebalancing provisions, use of new monies, and the review process.

- ***Diversification.*** This identifies the different asset classes required, the requirements of and limitations on domestic and foreign investment vehicles, capitalization requirements, and investment styles.

- ***Management procedures.*** This states whether the account should be managed actively or passively, whether the funds should be separate or pooled (and under what circumstances), and the criteria to be followed in selecting and terminating fund managers.

- ***Performance measurement.*** This sets intervals and timelines for fund-manager performance measurements and establishes benchmarks for doing so.

- ***Consultant selection.*** This establishes guidelines for determining consultant types (independent or in-house) and includes specific tasks.

- ***Investment limitations.*** This outlines regulatory procedures fund managers should follow, social or ethical constraints, diversification requirements (including excluded asset classes or vehicles), and prudence issues directors and managers must follow in forming policy and implementing investment goals and objectives.

- ***Communications requirements.*** This establishes the communications expectations for everyone involved in the process—managers, consultants, and custodians—and identifies how they should provide written input regarding appropriate adjustments to investment policies and objectives and performance review.

- ***Conflict of interest.*** This enumerates a clear expectation that all parties will comply with state and federal regulations, particularly as they apply to self-dealing.

- ***Effective date(s) of investment policy.*** This sets dates by which policies become effective and establishes specific procedures for reviews and updates.

- ***Glossary.*** This describes agreed-upon definitions for terms used in the document. A glossary can forestall many problems.

- ***Conclusion.*** This summarizes the spirit and fundamental intent of the investment and spending policy and reinforces the purposes of a policy document. Legal counsel should review the specific language of a summarizing statement and the entire document, but the document generally should include three basic concepts: (1) The document should be used as a guideline to assist the foundation's board of directors, investment committee, investment consultant, and investment managers; (2) it should not be considered a legal document or contractual obligation; and (3) it should be viewed as flexible to help everyone involved manage the foundation's assets effectively.

Three subsequent activities are essential: creating a statement of investment goals and objectives and an asset-allocation plan, hiring an asset manager (an individual, a firm, or both), and preparing managers' profiles. To help manage these complex activities, investment committee members might consider dividing them among three work plans.

WORK PLAN ONE: ***Develop an Investment Goals and Objectives Statement and an Asset-Allocation Plan.*** The statement and plan are intricate and comprehensive documents, and the process for developing them is equally complicated. Begin with a comprehensive work plan using a team consisting of the investment committee chair (or board designee), the chief investment staff officer of the foundation (or that person's designee), and the investment consultant. The three should ensure all other appropriate parties are involved in the plan's development and all

steps are followed. A successful process follows these steps:

- The team meets (optimally, all team members should be present) to gather and share information and help develop the written work plan that will guide the development of the policy statement.
- The investment consultant leads the development of an initial asset-allocation simulation and supervises data input.
- The investment committee (or the board, if desired) reviews the initial asset-allocation simulations and discusses options to enhance return and reduce risk.
- The team prepares a draft of the policy statement and refines the asset-allocation designation.
- The foundation directors review and approve the policy statement and the asset-allocation plan.

EVERYONE INVOLVED MUST RESIST THE TEMPTATION TO RECOMMEND SPECIFIC BROKERS OR FINANCIAL INSTITUTIONS THEY KNOW.

WORK PLAN TWO: ***Select an Asset Manager.*** Once the board adopts the statement of investment goals and objectives and the asset-allocation plan, the investment committee must hire the appropriate manager(s). ("Manager" refers to an individual, a firm, or both.) Again, everyone involved must resist the temptation to recommend specific brokers or financial institutions they know. The foundation and institution should rely on the advice of the investment consultant and use a team approach to identify a list of potential fund managers. Although the process is too complex to describe in complete detail in this publication, a work-plan team should complete these key steps, summarized in the following:

- Determine the characteristics of an effective manager and prepare an initial list of managers to review. Pay particular attention to investment philosophies, the asset classes the foundation needs managed, performance, organizational structure, and geographic location.
- Develop a questionnaire to screen managers with the board or investment committee.
- Prepare a preliminary list of managers for the investment committee to review and discuss.
- Send questionnaires to the managers selected.
- Review the questionnaire responses and conduct interviews with semifinalists or gather new information about managers interviewed within the last six months.
- Prepare a profile on each semifinalist and help the committee compile a list of finalists (see next section).
- Assess finalists' presentations with the board and/or committee and evaluate finalists using agreed-upon criteria.
- Make the final selection and notify all managers interviewed.

In many cases, the team members also help transfer assets and funding to the newly hired managers and establish monitoring criteria that are consistent with the reasons the manager was selected.

WORK PLAN THREE: *Prepare a Manager Profile.* The investment consultant should prepare manager profiles for each semifinalist to provide sufficient information to the foundation board and staff so they can determine each candidate's potential.

The profile should summarize the characteristics of the management firm—its investment style (including its areas of expertise or specialty), information about how the manager constructs portfolios, its quality-control skills and consistency, expected performance characteristics, and whether it is an equity or fixed-asset firm. In addition, the summary should describe positive factors, special considerations, and style references to enable comparisons with other managers of similar style.

SIGNIFICANT CHANGES COULD FORETELL THE MANAGER'S DIMINISHED CAPACITY TO MEET THE FOUNDATION'S INVESTMENT OBJECTIVES IN THE FUTURE.

EVALUATION OF MANAGER(S). Once the manager(s) is hired and has assumed the management of the portfolio as prescribed, performance evaluation falls to the foundation or its representative. The foundation board—with the help of its investment consultant and professional staff—should develop relevant performance measures to ensure it can evaluate its manager accurately. The evaluation must be as complete as possible to provide relevant and impartial data for measuring current performance and future potential. Two questions are key: (1) How did the manager perform with regard to the stated key objectives of the investment plan? (2) How predictable was the manager's performance in terms of history, style, skills, and types of securities?

Managers should be evaluated within the framework of their own universe of investment managers, particularly for such changes as ownership of the firm, key executives, investment styles, and assets or accounts under management. Significant changes could foretell the manager's diminished capacity to meet the foundation's investment objectives in the future.

EVALUATION OF FUND PERFORMANCE. The board also must evaluate the performance of the fund itself. Five basic areas should be reviewed initially, but others may be added at the discretion of the board:

- ***Fund objectives.*** Are the fund's goals and objectives consistent with the institution's current needs as outlined in the plan? Are manager guidelines consistent with objectives? Are manager guidelines reasonable in light of current market and economic conditions?

FOUNDATION BOARDS MUST HAVE A CLEAR CONFLICT-OF-INTEREST POLICY, AND DIRECTORS MUST AVOID ANY POSSIBLE COMPROMISING SITUATION.

- ***Total fund performance relative to its objectives.*** What is the current asset mix and value of the portfolio? Has a significant shift in asset mix occurred? What performance results were achieved by each asset class and the total fund? Are managers performing in line with investment guidelines? How are managers performing in relation to the total market?
- ***Manager mix.*** Were assets allocated properly to the various manager styles? Was the mix of manager styles correct? Did manager performance achieve fund objectives? Was manager performance in line with similar managers?
- ***Manager skill tests.*** Did each manager add value through the use of investment skills? Would a passive-index fund provide similar results?
- ***Total fund characteristics.*** Were any changes made in the inventory of securities used by the managers? How is the portfolio likely to perform in the future?

SPECIAL ISSUES. Two special issues prevail among foundations. The first—the subject of legislation in some states—is actual or perceived conflict of interest. The 1980s witnessed several large-scale insider-trading scandals, and the public has become especially sensitive to this issue. Foundation boards must have a clear conflict-of-interest policy, and directors must avoid any possible compromising situation. Investment professionals or those from allied professions who serve on foundation boards must operate and behave in a manner that assures the public that no unethical behavior is occurring, and no such behavior would be encouraged or tolerated under any circumstances.

The second issue also gained notoriety in the 1980s when investments were viewed as a form of political or social expression. Social-issue or political-issue investing, as the practice became known, called into question the responsibilities of the foundation board as prudent investors. In response, many innovative investment vehicles were created in the 1990s to allow institutions to pursue these forms of investments. In so doing, an institution or foundation could register opposition to or support of certain positions or activities while honoring stated investment responsibilities. The appropriateness of such investment policies and practices remains a matter for the foundation board. The investment industry provides a wide array of investment choices for virtually any course of action.

A FINAL WORD. Foundation directors who invest and manage assets must be sensitive to three potentially volatile areas:

- how to assume responsibility for an unfamiliar and complex task in light of limited resources and high demand for increasing levels of revenue to carry out the noblest of plans;
- how to become truly committed to a course of action that requires unfamiliar skills, which, if misapplied, might make individuals or the foundation liable financially and civilly; and
- how to secure assistance from appropriate professionals in specialized areas of highly unstable careers, some of whom may be at the top of the field but still not be the best choice.

In terms of modern portfolio theory, the investment field is largely a cyclical business. Prudence remains the guiding principle.

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BOARD BASICS

This publication is part of **Board Basics**, an AGB series devoted to strengthening the effectiveness of governing boards and trustees. Board Basics comprises several topic clusters—The Fundamentals, Financial Matters, Fund-Raising, Academic Affairs, Leadership, Strategic Decision Making, Foundation Relations, and Effective Committees—each of which contains several booklets. Several assumptions underlie the series:

- Academic trusteeship grows increasingly ambiguous, and board members need concise, accessible, and focused information to help them carry out their complex fiduciary and stewardship responsibilities.
- Basic principles of trusteeship remain constant across higher education, regardless of institutional type, size, and mission. The series highlights these general principles to provide board members with a core of knowledge they can apply to their individual situations.
- The series addresses the distinguishing characteristics of academic trusteeship, especially as it differs in scope, substance, and focus from corporate directorships and other board service.

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